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BOOK REVIEW

Euan Sinclair: Option Trading—Pricing and Volatility Strategies and Techniques

John Wiley & Sons, 2010, 298 pages, approx. 70.00 USD

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The focus of *Option Trading*, as its title correctly states, is on the practical possibilities of gaining an edge in everyday option trading. Combining academic research and practical expertise, the book provides its readers with basic quantitative approaches to volatility measurement, hedging, money management, and trade evaluation. It is recommended to those seeking a quick and practical, yet thorough, introduction to the option trading profession.

Euan Sinclair divides his book into roughly three parts. He starts with a thorough introduction to options from a conceptual and historical viewpoint. The second part is devoted to pricing concepts and relationships. In the last section, the reader is introduced to basic trading strategies.

Interestingly, in Chapter 1, the author makes a contribution to the ongoing political debate on the necessity and social desirability of derivative markets. He provides a short survey of the history of options and shows that the basic principles behind them have longer history than stocks or bonds. Contrary to widespread perception, they are not an invention of the modern finance industry, although the rapid growth of derivative markets since their introduction on major exchanges 30 years ago may have contributed to this notion. He concludes that banning option trading would result in a financial economy with far higher costs of capital and less growth. In Chapters 2–5, Euan Sinclair introduces basic concepts and definitions regarding options and option markets. He discusses static arbitrage relationships, as well as dynamic hedging approaches. Having a grasp of these concepts and methods is crucial to properly understanding the binomial tree and Black/Scholes pricing frameworks introduced later. This part of the book should be viewed as an introduction to the

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remainder of the text. Although option pricing factors are independent of any particular valuation model, the description of option trading strategies is closely tied to the formalism and nomenclature introduced in the discussion of the Black/Scholes framework. Chapter 6 discusses various popular risk profiles that can be constructed by plain-vanilla calls and puts, such as call and put spreads, risk reversals, straddles, strangles, and butterfly spreads. The chapter contains a good discussion of how it is possible to profit from these positions and the risks involved. Chapters 7 and 8 set out a short, yet thorough, introduction to modeling implied and realized volatility. The author provides useful information on fallacies regarding the measurement of volatility.

The remainder of the text examines ways of implementing profitable option trading strategies. Chapter 9 contains a discussion of the expected value of a trading evaluation concept. The author points out that in an environment of limited capital, the widely used concept of expected returns is probably the wrong measure for gauging the attractiveness of trading strategies: although higher risk exposures enhance expected portfolio returns, the increasing chance of large drawdowns increases the risk of default. Therefore, Euan Sinclair suggests determining position sizes by the Kelly criterion, i.e., the size that maximizes expected portfolio *values*, not returns. Chapter 10 discusses market-making techniques and the possible risks these strategies entail. The author introduces the concepts of inventory-based and information-based market making. He treats ratio trading, ticking, leaning on orders, and flipping. Even if readers do not intend to engage in market making, this chapter will help them improving their trade execution. Volatility trading is covered in Chapter 11, including a discussion of practical and sophisticated ways to hedge volatility exposure. A short introduction to the risks and opportunities of expiration trading can be found in Chapter 12. Managing the risks involved in option trading is covered in Chapter 13.

Euan Sinclair is a highly experienced practitioner with a strong theoretical background. These attributes make his book well-suited for practitioners who need a short, yet rigorous, introduction to the techniques and concepts of option trading, as well as for readers with a strong theoretical background who want to learn how to put the concepts to practice. The author states that the book should enable beginners to trade professionally on legitimate trading desks of banks, hedge funds, or market-making firms. In general, he treats the topic of option trading with an appealing balance between relevance and rigor.